United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

77-7146

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P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 77-7146

DAVID GOLDBERG, suing derivatively in right and for the benefit of UNIVERSAL GAS AND OIL COMPANY, INC.,

Plaintiff-Appellant,

against

YAACOV MERIDOR, ET AL.,

Defendants-Appellees,

and

UNIVERSAL GAS & OIL COMPANY, INC.,

Nominal Defendant.

APPEAL FROM JUDGMENT OF UNITED STATES DISTRICT COURT
DISMISSING PLAINTIFF'S AMENDED COMPLAINT

PETITION FOR REHEARING WITH A SUGGESTION FOR A HEARING EN BANC

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TABLE OF CONTENTS

	Page
Preliminary Statement	1
Issue Presented	2
Statement of the Case	3
Argument.....	4
A. The Panel decision is inconsistent with the methodology adopted by the Supreme Court in interpreting Section 10(b) of the Act.....	5
B. The Panel majority erred in ruling that the requirement of materiality may be satisfied by the availability of injunctive relief in this case.....	10
Conclusion	15

TABLE OF AUTHORITIES

Statutes and Rules

Fed. R. Civ. P. 44.1	13
N.Y.B.C.L. § 626(c) (McKinney 1963)	6
N.Y.B.C.L. § 627 (McKinney Supp. 1977)	6, 11
N.Y.B.C.L. § 720 (McKinney 1963)	10
Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970)	2-9, 11, 14
Law of Panama Number 9 of July 3, 1946, Article 420	14
Law of Panama Number 9 of July 3, 1946, Article 444	13
Panama Judicial Code § 338	14
Panama Judicial Code § 339	14
Rule 10-b-5, 17 C.F.R. § 240.10b-5 (1977)	2-6, 14

Page

Cases

Birnbaum v. Newport Steel Corp., 193 F.2d, 461 (2nd Cir.) cert. denied 343 U.S. 956 (1952) 11

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 5, 6, 11

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 5, 6

Greenspan v. Lindley, 44 A.D.2d 20 (First Dept. 1974), aff'd., 36 N.Y.2d 473 (1975). 13

Hausmman v. Buckley, 299 F.2d 696 (2d Cir.); cert. denied 369 U.S. 885 (1962)..... 13

Ketchum v. Green, [current] CCH Fed. Sec. L. Dep. ¶96,107 (3rd Cir. June 30, 1977).. 9

Langfelder v. Universal Laboratories Inc., 293 N.Y. 200, 56 N.E.2d 550 (1944) 12

Lanza v. Drexel, 479 F.2d 1277 (2nd Cir. 1973). 5

Levy v. Pacific Eastern Corp., 153 Misc. 488, 275 N.Y.S. 291 (Sup. Ct. 1934)..... 12

Santa Fe Industries, Inc. v. Green, ___ U.S. ___, 51 L. Ed.2d 480 (1977) 2, 5, 6, 8, 9, 11

Schoenbaum v. Firstbrook, 405 F.2d 215 (2nd Cir. 1968 cert. denied 395 U.S. 906 (1964) 7

Sternfeld v. Toxaway Tanning Co., 290 N.Y. 294, 49 N.E.2d 145 (1943) 12

Superintendant of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) 9

TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) 10

Miscellaneous

Conference Report, H.R. Rep. No. 1838, 73rd Cong., 2d Sess. (1934) 7

5 Moore's Federal Practice ¶144.1.05..... 13

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PRELIMINARY STATEMENT

Defendant-Appellees submit this brief in support of their motion for a rehearing and suggestion that this Court convene en banc to consider this case.

ISSUE PRESENTED

Do Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (b) (1970) (the "Act"), and Rule 10b-5, 17 CFR § 240.10b-5 (1977) promulgated thereunder embrace a derivative claim for waste of corporate assets involving the prospective issuance of securities where it is not alleged that the derivative corporation was deceived?

Appellees submit that this issue should be reconsidered by this Court and suggest that its importance warrants full briefing and consideration by this Court en banc. Neither the language nor the legislative history of Section 10(b) of the Act contains any indication that Congress ever sought to cover such transactions and the panel decision in this case is at odds with both the methodology and teaching of the recent Supreme Court cases including Santa Fe Industries, Inc. v. Green, ____ U.S. ____, 51 L.Ed.2d 480 (1977).

Further, appellees submit that the panel's test - the availability of injunctive relief at the request of minority shareholders as a basis of determining whether Section 10(b) and Rule 10b-5 embrace state law claims of waste - is basically flawed, at least as applied in this case. Such a test makes the application of a federal statute

turn on whether the forum state permits injunctive relief. In this case, moreover, the plaintiff has conceded his unwillingness to post a bond as required by New York law to bring a derivative suit and, consequently, his unwillingness to post a bond as a condition to preliminary injunctive relief. Appellees submit that whether a derivative plaintiff should be permitted to so easily avoid the strictures of a state law claim, although the existence of such a claim permits, under the panel's decision, his federal claim to stand, should be reconsidered by this Court. Such reconsideration is particularaly appropriate where the derivative corporation is a Panamanian corporation and the Court, having raised the question of Panamanian law, is informed that Panamanian law would bar this action.

STATEMENT OF THE CASE

In this derivative action brought pursuant to § 10(b) the Act and Rule 10(b)(5) plaintiff charges that the officers and directors of the Universal Gas and Oil Company, Inc. ("UGO"), in conspiracy with others, breached their fiduciary duties by wasting and mismanaging UGO's assets. It is alleged that that waste and mismanagement was achieved in part by exchanging UGO assets, including the elimination of a debt owed UGO, in connection with the prospective

issuance by UGO of shares of its unregistered treasury stock. No allegation was made that the officers and directors of the corporation were deceived. Furthermore, the issuance of treasury stock has not occurred.

On February 10, 1977, Judge Lasker issued an opinion and order granting the motion by a majority of the defendants-appellees and the nominal defendant UGO to dismiss Goldberg's Amended Complaint for failure to state a claim, holding that deception was an indispensable element of a 10(b) claim and that the amended complaint was fatally defective in failing to allege deception. Additionally the Court in dismissing the complaint noted that plaintiff's complaint was a "prime example [...] of an attempt to fit the square peg of a state law claim into the round hole of a 10b-5 allegation."

On September 8, 1977, a panel of this Court* reversed.

ARGUMENT

This case has called upon this Court to consider still another aspect of the private cause of action judicially envolving from the proscriptions of Section 10(b) and Rule 10b-5. But this case differs markedly from those concerning

* Circuit Judges Friendly, Timbers and Meskill. Judge Meskill concurred in part and dissented in part.

merely whether certain elements of common law fraud are to be found in that section and rule.[1] Rather, this case broadly involves whether those proscriptions are to be applied to garden variety state law claims of waste of corporate assets where the corporation was not deceived, merely because the transaction involves a security and merely because the forum state might permit injunctive relief at the instance of a minority shareholder having no right to vote on the transaction, had that minority shareholder been told all material facts.

A. The Panel Decision is Inconsistent with the Methodology Adopted by the Supreme Court in Interpreting Section 10(b) of the Act.

In the last two years, the Supreme Court has charted a clear path to be followed by the federal courts in assessing whether Section 10(b) encompasses a particular claim. It has forcefully reiterated that the creation and elaboration of a private cause of action for damages under Section 10(b) of the Act and Rule 10b-5 is an exercise in the construction of the language of these provisions themselves. See, e.g., Santa Fe Ind. Inc. v. Green ("Santa Fe"), ___ U.S. ___, 51 L.Ed. 2d 480, 491-492 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-200, 206 (1976) ("Hochfelder"); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756, (1975) (Powell, J. concurring) ("Blue Chip").

1. E.g., Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc).

First, the Court has ruled that the language of the statute must be examined. Santa Fe, supra at 491, Hochfelder, supra at 197; Blue Chip, supra at 733-34, 756. Here there is no indication in the language of the section that Congress intended § 10(b) to embrace a claim for waste of corporate assets through the device of a security and thereby negate the carefully drawn limitations the various states have attached to derivative actions pleading such claims.[2] Similarly, the language of Rule 10b-5 gives not the slightest indication that the Commissioners intended it to cover such transactions. Had Congress and the Commission intended otherwise, they surely could have found the language to do so.

Second, the Supreme Court has further ruled that if the language of Section 10b is ambiguous in regard to the issue before the Court, the legislative history should be examined to determine whether Congress intended the statute to embrace the claim. See, e.g., Santa Fe, supra at 492; Hochfelder, supra at 201; Blue Chip, supra at 756. While the language here is clearly unambiguous and reflects no intention to cover such claims, the legislative history is totally devoid of any expression by Congress of any intent to convert a normal state court claim for waste of corporate assets into a federal securities law claim merely

2. See, e.g., N.Y.B.C.L. § 627 (McKinney Supp. 1977) (security for costs provision); N.Y.B.C.L. § 626(c) (McKinney 1963) (requiring demand on directors).

because a security was involved in the transaction. See, e.g., Conference Report, H.R. Rep. No. 1838, 73rd Cong., 2d Sess. (1934).

Indeed, it is alleged that the issuance of unregistered stock is the means by which corporate assets were allegedly depleted here, as well as in Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied 395 U.S. 906 (1969), and similar cases, the legislative history with regard to Section 10(b) of the Act is particularly instructive. In its original form, Section 10(b) (then 9(c)) embraced only securities listed on a national exchange. Only at the Senate House Conference was the final wording of "any security not so registered" added to the section. Congress viewed that change as so inconsequential that it was not even discussed in the Conference Committee Report. Since that phrase is the sole warrant for regulating off-exchange transactions, it seems incredulous that Congress should have intended to make a matter of federal regulation those state law claims involving corporate waste, without a single whisper that it intended to do so.

The panel decision in this case strays from the methodology ordered by the Court. Never does it address either of these two fundamental tenets of statutory construction.

A rehearing should be ordered to consider the scope of Congressional intent. Because of the gravity of the question, we suggest that the rehearing be en banc.

In addition, the decision is seemingly at odds with the most recent Supreme Court decision, Santa Fe Industries, Inc. v. Green, supra. There, the Court articulated a reluctance both to imply a federal cause of action "to serve what is 'at best a subsidiary purpose' of the federal legislation," and "to federalize the substantial portion of the law of corporations that deals with transactions in securities..." Santa Fe, supra at 495-96. Although the existence of a state law remedy does not determine whether a federal claim exists, the Supreme Court in Santa Fe found it entirely proper to refer plaintiffs to their state law remedies where a contrary holding would lead to fine and arbitrary distinctions between one transaction and another and would overlap or interfere with state corporate law.

Here the majority opinion brings about just such a result. Despite the panel's apparent disavowal of the "controlling influence" and "wholly inadequate consideration" standards as a basis for § 10(b) claims, the decision utilizes these concepts to imply deception of minority shareholders. Thus, the panel majority rules that deception may be found in a derivative suit whenever controlling shareholders or

directors fail to disclose their waste or mismanagement of corporate assets and a security is somehow remotely involved.

The majority opinion highlights clearly the difficulty of adhering to the language of § 10(b) and the Congressional intent when § 10(b) is utilized to enforce essentially state law claims. Protection of non-purchasing or non-selling shareholders against improvident corporate transactions enjoys no warrant in the statutory language or legislative history and is "at best a subsidiary purpose" in the judicial evolution of § 10(b).[3] The majority has, we submit, failed to adhere to the rationale underlying Santa Fe and has gone beyond the intended scope of § 10(b). Its decision should be reconsidered, we suggest, by an en banc court.

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3. In support of its holding, the majority attempted to gain some comfort from Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S.6 (1971). But Bankers Life is no warrant for converting a state law claim of waste of assets into a violation of federal law. As Judge Adams recently wrote for the Third Circuit in Ketchum v. Green, [current] CCH Fed. Sec. L.Rep. ¶ 96,107 (3rd Cir. June 30, 1977),

> "We do not believe, however, that Bankers Life was intended to be so encompassing in its embrace. Justice Douglas emphasized, quite explicitly, that not all intra-corporate controversies fall within the scope of § 10(b). Indeed, his opinion states that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. If the present action essentially involves an instance of internal corporate mismanagement, then it would appear that the 'touch' test of Bankers Life would not draw this lawsuit within the coverage of § 10(b)." Ibid, at 91,988 (emphasis added) (footnote omitted).

B. The Panel Majority Erred In Ruling That the Requirement of Materiality May be Satisfied by the Availability of Injunctive Relief in this Case.

The panel majority found that the complaint below would have been amended to allege a deception by means of two press releases. It then noted that minority shareholders' approval of the transaction was never sought nor needed, and they, consequently, never made any investment decision with respect to the transaction or in reliance on the press releases. The panel majority thereupon reasoned that, nevertheless, the material requirement as anticipated by the text of the rule and the Supreme Court's ruling in TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976), could be satisfied by ruling the plaintiff could have attained an injunction in a state law derivative action. In general, and particularly with respect to this case, this reasoning is flawed in several respects.[4]

As Judge Meskill makes clear in his dissent, this reasoning further immerses the federal judiciary into questions of state law and makes the application of a federal statute

4. The majority also averted to the claimed deception of one UGO director. Nowhere, however, is it claimed that the remaining directors did not know the truth. Consequently, whether that one director was deceived is immaterial since it is not alleged that a change in his vote would have changed the result. Moreover, analysis of that director's ability to sue under N.Y.B.C.L. §720 (McKinney 1963) is the same as the analysis of plaintiff's ability to sue under New York law as a shareholder. See infra.

dependent upon state law rules. In view of the widely-held notion and the statement by the panel majority that the applicability of a § 10(b) claim does not turn upon state law, the result is anomalous.

It becomes further anomalous in its emphasis on an investor's decision to sue rather than an investor's decision to purchase or sell securities. Such a ruling hardly squares with this Court's and the Supreme Court's reasoning that § 10(b) is designed to preclude deception affecting investment decisions. Santa Fe, supra; Blue Chip, supra; Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.) cert. denied 343 U.S.956 (1952).

But general considerations are not the only reason for rehearing this case. Here reliance on the availability of an injunction is particularly inappropriate. The UGO shares have remained with UGO (see Affidavit of J. Portis Hicks sworn to June 1, 1976 Appendix A 21) and plaintiff has yet to seek an injunction, even in his companion state court action. Indeed, in this federal action plaintiff chose to drop his state corporate waste claim rather than post security for costs as required by state law. N.Y.B.C.L. § 627 (McKinney Supp. 1977). Thus, the majority's ruling that the plaintiff, had the press releases been accurate, would have brought a state court action, posted a § 627 bond and then posted additional security in connection with a preliminary injunction has pushed this case into the world of fiction.

Moreover, a New York court would not have entertained plaintiff's case. In seeking an injunction, Goldberg, as he admits in his pleadings, would have been assailing a reorganization of a Panamanian corporate subsidiary by a Panamanian corporate parent through the exchange of stock of the subsidiary for substantially all the assets and liabilities of the parent. In such cases involving internal corporate affairs, New York courts have refused to take jurisdiction. See Sternfeld v. Toxaway Tanning Co., 290 N.Y. 294, 49 N.E.2d 145 (1943) [plaintiff sought an injunction against unlawful issuance of stock by a foreign corporation; held although fraud was alleged, New York courts would decline to entertain jurisdiction] see, also, Langfelder v. Universal Laboratories Inc., 293 N.Y. 200, 56 N.E.2d 550 (1944) where the New York courts declined to become involved in the regulation of the internal affairs and management of a foreign corporation, despite the fact that

> "the several foreign corporations [had] their manufacturing plants and the place of business where the principal affairs of the corporation [were] tansacted and their records kept within ... New York ...."[5]

5. We respectfully submit that all the cases but one cited by the majority in support of the contention that a New York injunction would issue are inapposite. They involve New York corporations as defendants, not foreign corporations. The one involving a foreign corporation, Levy v. Pacific Eastern Corp., 153 Misc. 488, 275 N.Y.S. 291 (Sup. Ct. 1934) is hardly persuasive precedent in the face of Sternfeld and Langfelder, supra.

Furthermore, were a New York court to entertain such an action, it would apply Panamanian law. As noted by this court in Hausman v. Buckley, 299 F.2d 696, 702-04 (2d Cir.) 1962, cert. denied 369 U.S. 885 (1962), in choosing the appropriate law in cases involving the internal management and affairs of corporations, New York courts look to the state or country of incorporation - even if the result deprives plaintiff of his right to sue derivatively. See also, Greenspun v. Lindley, 44 A.D.2d 20, 22, (First Dept. 1974), aff'd 36 N.Y.S.2d 473 (1975).[6]

The Panamanian statutory scheme for internal management of the affairs of Panamanian corporations, for the protection of shareholders of such corporations and for the institution of litigation by such shareholders for corporate waste and mismanagement is substantially similar to the law of Venezuela enforced in Hausman v. Buckley, supra. Any liability for mismanagement can only be enforced through a resolution of the general stockholders' meeting. Law of Panama Number 9 of July 3, 1946, Article 444. The statute further provides that a shareholder could not require that

6. Before the panel, no party briefed the nature of Panamanian law and although the majority of the panel indicated that it needed guidance on that question, (see page 5824 of the panel's decision) no additional briefs were required. Accordingly, and pursuant to F.R.C.P. 44.1; see 5 Moore's Federal Practice ¶ 44.1.05 it is appropriate to discuss the foreign law issue at this stage.

such a meeting be called nor could he petition a Panamanian court to call it unless he owned or represented 5% of the shares. Id., Article 420. Additionally, if such a meeting were called, and if a resolution were passed authorizing a suit against the directors, then only persons specifically authorized by power of attorney from the directors, or certain other officers enumerated by statute could represent the corporation. Panama Judicial Code, §§ 338, 339.

Notwithstanding that he invested in a Panamanian corporation, plaintiff has failed to avail himself of any of these procedures. Under these circumstances, it is clear that plaintiff could not have obtained an injunction in New York or Panama against the transaction.

Consequently, the use of the fictional device of an injunction raises the disturbing spectre that the application of a federal statute will turn on state law, imports into the calculus of disclosure required by § 10(b) and Rule 10b-5 whether the information will affect, not an investment decision, but a decision to litigate, and, in this case is particularly inappropriate, because the state courts here would not have issued an injunction. We submit that such a fiction should be discarded or, at least, that this court should decide, en banc, whether it should be permitted to exist.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that petitioners' request for a rehearing be granted and that the rehearing be en banc.

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CERTIFICATE OF SERVICE

The undersigned, a member of the Bar of this Court, hereby certifies that true copies of the foregoing have been duly served, by hand delivery or by mail, on counsel for all parties who have appeared in the above action, on the 22nd day of September, 1977.

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Dated: September 22, 1977

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